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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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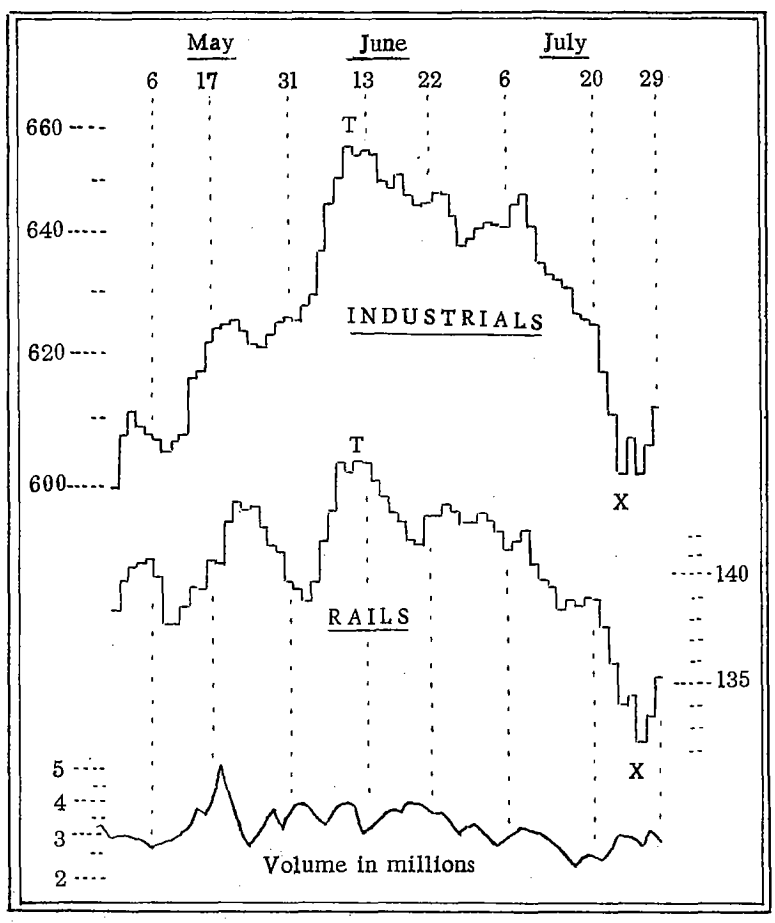
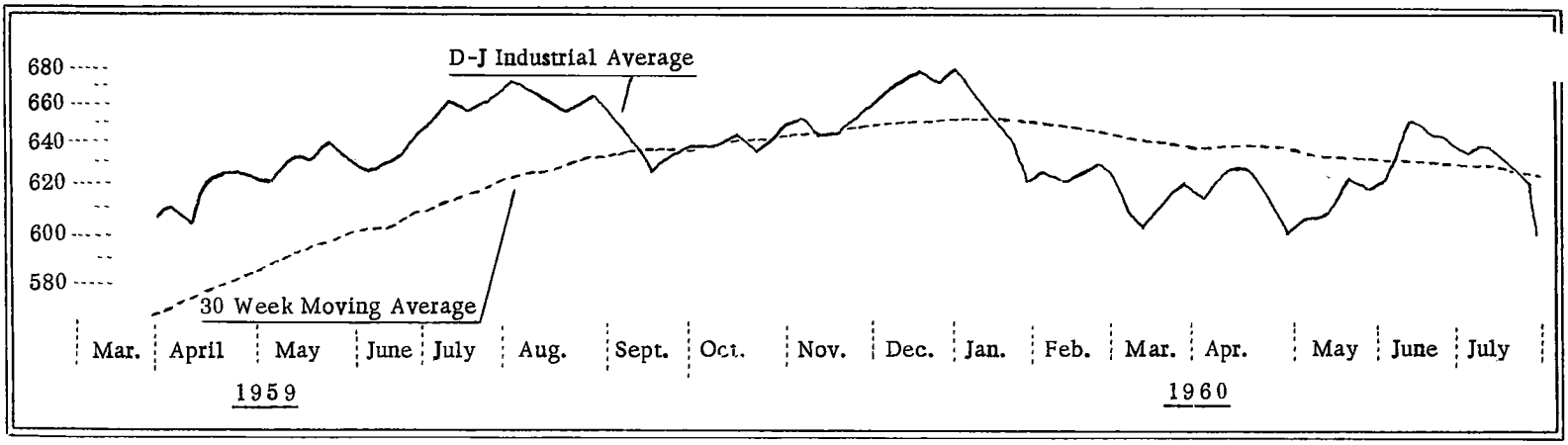
PRICE MOVEMENTS Continuing the retreat from T (656.42), Industrials touched a low of 601.68 (X - see chart) on July 25. This Industrial low came at the end of an almost unprecedented string of eleven consecutive days of decline. Two days later Rails sagged to a new bear market low of 132.37 (X). On July 27, after the close of the market, the Fed announced that stock margins would be lowered from 90% to 70%. The margin change together with the oversold condition of the market sparked an immediate rally, and on July 29 Industrials rose 11.06 points. Less bullish, however, were the odd-lot ratios. On July 28 and 29 they swung to the heaviest buy balances in months. "Professionals Buying - General Public Expected To Come In Later", headlined the N.Y. Times' market column on July 30. But the odd-lot ratios suggested that the public was hardly waiting to do its buying.

As mentioned previously, many reversals have occurred in areas where one Average would not confirm the penetration of the other through a critical point. This happened in March when Rails went to a new bear market low of 137.68 while Industrials held persistently above their own bear market low of 599.10. The subsequent rally advanced Industrials to 656.42 (T), Rails to 146.01. On the recent sell-off Rails broke to another new bear market low of 132.37 (X). Industrials have again refused (at least so far) to violate 599.10.

In the last Letter I noted that "when critical points are approached it is not unusual for the Averages to become extremely erratic. Often violent upside movements will occur (giving the appearance of the Averages' fighting or resisting the penetration." If we consider that (1) critical points were approached, (2) Industrials would not confirm the Rail weakness. and (3) the drop since mid-June was precipitous and uncorrected, we must also accept the possibility that the rally may now retrace 1/3 to 2/3 of the ground lost since T. This could mean an Industrial advance to the 620-638 area. Extreme Rail sluggishness or divergence could be the first sign that the rally was fizzling. Volume petering out on the advance might also signal that the upward move was ending.



THE MOVING AVERAGE POINTS One of the more interesting technical studies is the relationship of the D-J Industrial Average to its own long-term moving average. Some market students keep a 200 day moving average; I find that a 30 week moving average is easiest to keep.



Each Wednesday's Industrial closing (Wednesday was picked at random) is added to a list of the 30 preceding Wednesday closings. As each new figure is added, the oldest figure is dropped. The total of the 30 closings is then divided by 30 which gives a 30 week moving average of the D-J Industrials. The process is repeated each week.

It is a fairly uniform experience that during bull markets the Industrial Average tends to hold above its long-term moving average; in bear markets it tends to remain below its long-term moving average. Periodic reactions may penetrate above or below the moving average, but when these penetrations occur against the primary direction they usually constitute a buying or selling opportunity.

In July, 1957, the Industrial Average dropped under its moving average; for almost ten months it remained in this area while recession clouds gathered. Then in May, 1958, the Industrial Average rose above its 30 week moving average. Since (1) the primary trend was up and (2) the market was in a strong technical position, this upward penetration was taken to be extremely bullish. Market students at that time had only to ask the following question: considering the prevailing bearish (recession) psychology, why had investors suddenly bid the D-J Industrial Average up over its 30 week average price? The answer was obvious -- informed investors (the type who buy the Dow stocks) sensed that there was to be a fundamental improvement in corporate earnings during the period ahead.

An historic advance followed the upward penetration of the 30 week moving average. During the remainder of 1958 and the first half of 1959 the Industrial Average (see chart) held well above its thirty week moving average. It was on this advance that the bull market's third phase reached its climax. Then in September, 1959, the Industrial average plunged under the moving average for the first time in sixteen months. The penetration proved to be an important warning signal. Following a new advance which reached a peak in January, 1960, Industrials again sank below the moving average. Two months later, in March, the bear market signal was given.

The recent May-June (upward) reaction saw the Industrial Average again rise temporarily above its moving average. In bear markets of the past these upward penetrations of the moving average have signalled important selling and short-selling areas. Sales and short sales in the June area have, in fact, already proved profitable.

The moving average hit its peak in Mid-January, following which it began its gradual decline. Last week the moving average stood at 625.72, a point which could act as an invisible barrier during any near-term rally.

SHORT OPERATIONS. I have been reviewing all short recommendations made since the bear signal. The large majority of these have worked out well. A few have gone against the trend such as Standard Packaging and Gabriel; others such as Reynolds Metals, Mead and Chrysler have dropped spectacularly. The question arises as to when shorts should be covered. On an extended decline I often cover half of my short commitments so that a certain portion of profits are insured. I then place "stop-buy" orders a few points below the level at which each individual stock was shorted. This means that if I am caught in a sustained

rally my remaining shorts will be cleaned out with enough to spare so that commissions are paid for. If the rally expires without touching off stop-buy orders, I will usually ride the rest of the shorts through the next decline.

The most difficult part of shorting is in assuming commitments and having them go immediately against you. In this event, one should always have a theoretical point beyond which he will not take a further loss. A good trader would rather sustain five small losses than one large one. The former is also easier on the nerves. It should be remembered, however, that the short seller in a bear market has one thing in his favor -- time. The primary tide in a bear market usually ends by taking almost everything with it (the exact converse, of course, of the bull tide).

WORDS Each era seems to generate its low peculiar brand of nonsense. Thirty years ago the phrase "basically sound" was widely used to describe the high-flying market and economy of the Twenties. During 1928 and '29 the additional expression "permanently high plateau" was added to the list of cliches. Both of these phrases became standing jokes some few months after 1929.

Over the last few years the word "growth" has gathered a breathless following. An up-sloping "growth chart" is applied to everything from the newest stock floatation to Consolidated Edison common. This type of thinking is supposed to imply that in the normal course of events everything continually and perpetually "grows". Dow and Hamilton never believed this, and neither does anybody else who has studied history or physics. In fact, Hamilton often warned his readers against eternal bullishness with the words, "No tree grows to the sky."

Dow wrote about the inevitable ups and downs of the economy as follows:

> "If all corporations were rich and conservative prices might be expected to become stable and periods of depression might disappear. If all individuals were rich and conservative, panics and hard times might disappear. But as long as corporations and individuals differ greatly in resources, but are alike in the desire to make money, there will continue to be elemental conditions likely to produce instability, and enough toppling over to produce cycles of depression.
>
> "Falling prices are produced by falling profits. Falling profits are caused by an excess of supply over demand. Excessive supply is always the result of overdoing, and over-trading is generally the result of haste to be rich. Until some link in this chain is broken we think the lamp of experience will continue to flicker."

In the July 9, 1960, issue of Business Week the use of the word "growth" reached a new high in absurdity. Referring to Canada's slumping economy and high rate of unemployment, Business Week entitled their article, "Slowdown of Growth Rate Pinches Canada's Economy." If we carry this type of "thinking" to its logical conclusion, our next recession will probably be labelled "a collapse in the growth rate."

QUESTION. "In early July the D-J Utility Average hit a bull market high above the old 94.70 point. Isn't this a bullish sign?"

ANSWER It isn't as far as the Dow Theory is concerned. As previously mentioned, a study of the price movement over the past 64 years points up the hopelessness of attempting to draw conclusions based on the movements of the utilities. There have been periods such as 1947 and '48 wherein the Utility Average moved persistently against the primary trend of the market as indicated by the Industrial and Rail Averages.

NOTES During the May-June advance which followed the bear signal, newspaper columnists and market experts devoted a good deal of time and space to ridiculing Dow's Theory. Men who have never studied Dow's or anybody else's methods gleefully explained to their readers why the principles which have stood the test of 64 years could not and would not work any longer. It was widely held that the movements of "the antiquated Rail Average" had lost their significance in the new world of electronics and "wonder drugs". Moreover, it was said that Dow's Theory was absurd because the bear signal came too late (this despite the fact that no informed Dow Theorist ever waits for a bear signal before selling).

Judging from a good deal of correspondence received here, however, it seems evident that Dow's Theory continues to serve many informed investors. I try to publish occasional letters from readers, particularly when I think these letters may aid other readers in understanding the market. Following are excerpts from a letter received last week; the writer is a physician.

"Your articles in Barron's made me very aware of the meaning of the Dow Theory. I did not learn what I have overnight. It has been hard work and plenty of it. At the present time I have been out of the market since the first part of the year, most of the sales being made in January.

"Now the critical evaluation of whether or not learning the principles of Dow, Hamilton and Rhea have been worth all the "hard work and plenty of it." Here are the data, and please realize that I did not like some of the prices obtained at the time.

Common Stock	Sale Price	Closing Price 7/25	% Decrease
Amerada	84	55	34.6
Am Metal Cl	26 1/8	22 5/8	13.1
Int. Paper	127 1/2	95 1/2	25.0
Monsanto	55 5/8	37 7/8	32.0
Royal Dutch	43	33 5/8	21.8
Reynolds Metals	61	46	24.6
Reynolds Metals pfd. cv.	147 3/4	114 7/8	22.4

Average % decrease 24.8%

"What this really means is that the buying power of our money has increased 24.8% since the first of the year. And this is not the end as this is just the end of Phase I or slipping over into the first part of Phase II of a bear market. I have made over $20,000.00 by just staying out of the market. Has it paid to be a student of the Dow Theorists? You bet it has. Again, thank you for stimulating my few functioning brain cells."

DEATH KNELL FOR INFLATION Last week the Dow Jones Spot (immediate) Commodity Index dropped to the lowest point since the Index was first compiled in 1950. During the same week the D-J Futures Commodity Index sagged to the lowest level since March, 1950. With the price of raw materials going down or deflating there is little incentive for anyone to build or speculate on inventories.

READING AND STUDIES An excellent and informative treatise on Government securities has been written by my friend J. Irving Weiss. It is entitled, "How To Get The Most Profit and Income From Government Securities" (published by Capital Counsellors, 50 Broad Street, New York 4 -- price $2.00).

For Canadian Stock Charts and technical information write Mr. Iain Fraser, 199 Bay St., Toronto 1, Canada. He publishes the only available daily charts on Canadian stocks.

I have printed graphs (arithmetic scale) suitable for charting the D-J closings and volume. Paper is 8 1/2 x 11 and is finest grade rag stock; price 10 sheets for a dollar, postpaid. I have consistently recommended that all market students chart the closings; there is no better way of understanding the price movements.

STOCKS Again I am going to recommend the Gold stocks for purchase. Campbell Red Lake has recently broken out of an ascending triangle and is a buy at the market. Try to buy it around 11. Dome formed a double bottom at 17, then climbed above its previous peak at 19. Try to buy it around 19.

Columbian Carbon is a short sale at a close of 43 or below. Olin Mathieson is a short at the market as is National Gypsum. 52 39 3/4

(Written Monday, August 1st - 2 P.M.)